Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
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Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket No. 92-266
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket No. 93-215

COMMENTS OF THE NATIONAL CABLE TELEVISION ASSOCIATION ON THE SEVENTH NOTICE OF PROPOSED RULEMAKING

The National Cable Television Association, Inc. ("NCTA"), by its attorneys, hereby submits its comments in the Seventh Notice of Proposed Rulemaking in the above-captioned proceeding. NCTA is the principal trade association of the cable television industry in the United States. Its members include cable television operators and cable television program networks, as well as equipment suppliers and others affiliated with or interested in the cable television industry.

INTRODUCTION

In this Seventh Notice of Proposed Rulemaking, the Commission proposes to revise its rules governing programming costs. Those rules allow cable operators to pass through to subscribers all programming cost increases for existing services carried on regulated service tiers, and to add a mark-up of 7.5 percent.[1] Now, less than a year after issuing its rules and

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[1] See FCC Form 1210 (May 1994).

Under the revised going forward rules adopted by the Commission in November 1994, an operator may not include a 7.5 percent markup on programming cost increases for channels added under the new rules. Those rules allow operators to increase their rates by 20 cents per channel, up to an Operator's Cap of $1.20, plus programming fees, up to a license fee associated forms governing pass throughs, the Notice proposes to reverse course to disallow the 7.5 percent markup on programming cost increases. Operators, therefore, would be limited to recovering only the programming cost increase itself, and would be denied any profit on that increase.

The Commission should abandon this proposal. Eliminating a markup on programming cost increases will unfairly disadvantage programmers already carried on regulated tiers by taking away incentives for cable operators to invest in their programming. This would disserve the Commission's mission to "promote the availability to the public of a diversity of views and information through cable television and other video distribution media." Cable Television Consumer Protection and Competition Act of 1992, Section 2(b)(1). In order not to undermine this goal, and to provide at least some incentives for operators and programmers carried on a regulated tier to expand and improve their program services, at a minimum the 7.5 percent markup should be retained.

Moreover, the Commission has not identified any problem justifying revisiting the issue of the proper calculation of programming costs. Under these circumstances, the continual reopening of the rate rules will fail to provide the industry with the certainty in this area that it sorely needs.

ARGUMENT

I. The Notice Fails To Justify Eliminating The Markup

The Commission proposes to jettison its existing markup on programming cost increases based on the two faulty presumptions. First, the Commission incorrectly assumes that its new going forward rules somehow obviate the need for a markup on existing programming costs. Second, the Notice questions whether allowing a markup, even for those systems that do not

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cap of 30 cents, over a 2 year period. Operators electing to use the new going forward rules may only pass through the actual costs of the programming carried on a channel for which it obtained a 20 cent per channel markup. 47 C.F.R. §76.922(d)(3)(xi).

take increases under the new going forward formula, serves any policy goals. As demonstrated below, these erroneous assumptions do not justify eliminating the markup.

A. The FCC's Proposal Is Premised On The Erroneous Assumption That The 7.5 Percent Pass Through and The 20 Cent Per Channel Adjustment Are Related

The Notice posits that operators adding channels under the new going forward formula may no longer need a markup on channels already carried on the system "given the total incentive structure provided in our revised going forward rules."[2] The Commission thus proposes not to allow operators that take a 20 cent per channel increase for channels newly added to the system under the revised going forward formula to add a minimal markup of 7.5 percent for programming cost increases on entirely different channels already carried on the system. However, no nexus exists between the markup provided for channels newly added to the system and the markup on programming costs already carried on regulated tiers. And the Notice fails to articulate any valid reason why they would be linked.

The new going forward rules deal with an entirely discrete matter -- the markup the Commission found appropriate to provide incentives for operators to add new services to regulated tiers. Neither the 20 cent per channel adjustment, nor the total package of revised going forward rules, justify deletion of the markup on increases in programming costs for networks already carried on those tiers.

There is no evidence that the 20 cent per channel markup includes an allowance for a profit on increased programming costs on existing channels. In adopting the revised going forward rules, the Commission explained that "the [20 cent] channel adjustment factor will compensate the operator for its costs of adding the channel plus a reasonable profit. Twenty cents falls within the historical range of 15-22 cents by which operators in a competitive environment would adjust rates for the addition of a new programming channel, exclusive of

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2 Notice, ¶133.

programming costs."[3] The Technical Appendix accompanying the new going forward rules which describes the Commission's methodology for deriving the 20 cent markup also fails to evidence any consideration of programming cost increases on existing channels. As the Technical Appendix describes, "our methodology in examining the per channel adjustment factor was to estimate the current cost of adding a new channel under competitive conditions. . . [W]e estimate the cost of a channel addition from historical data."[4]

The Commission has therefore justified the revised going forward rules and the 20 cent markup based on the amount deemed appropriate to provide an incentive to add new channels to an existing tier of service. There is no evidence that 20 cents is the total amount of compensation necessary to replicate the behavior of competitive systems when channels were added and programming costs on other channels increased, or that the 20 cents would be sufficient to provide operators with a reasonable profit on both newly added channels and increases in the programming costs for other channels.[5] As a result, there is no reason to penalize operators and existing programmers by stripping them of a markup on these services merely because the operator adds new services.

Further, there is no reason to assume that operators who will experience programming cost increases will choose or be able to take advantage of the 20 cent markup. Some operators may decide to add programming networks only as part of New Product Tiers. Others will for the near term be adding no channels on any basis because of a lack of channel capacity. Still others

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[3] Sixth Order on Reconsideration, Fifth Report and Order, and Seventh Notice of Proposed Rulemaking, MM Docket Nos., 92-266, 93-215 (rel. Nov. 18, 1994) at ¶ 73 (emphasis supplied).

[4] Technical Appendix at 4 (emphasis supplied).

[5] The Commission in adopting the 20 cent per channel markup prohibited operators from taking an additional markup where programming costs increased for those channels. The Commission reasoned that "the per channel adjustment of up to 20 cents for additional channels, in addition to the License Fee Reserve, will provide full and fair compensation to operators adding channels to CPSTs." Notice, ¶83.

may add channels to the basic tier, to which the 20 cent markup does not apply. For these operators, there will be no way to recover the proposed loss of 7.5% from any source.

B. The Rules' Incentive Structure Does Not Justify Eliminating the Markup

There is similarly no basis for the Notice's suggestion that the "total incentive structure provided in the revised going forward rules"[6] supports the elimination of markups on existing programming networks. The new rules are designed to provide "[a]ppropriate incentives for adding new channels" to cable programming service tiers.[7] They are not designed to provide incentives for investments in existing programming services -- nor do they.

Instead, the Commission has already determined that for these services, a 7.5 percent markup is appropriate to provide incentives. In its Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking,[8] the Commission found that a markup on new programming expenses was necessary to "[h]elp assure the continued growth of programming services...."[9] The FCC believed that the 7.5 percent markup, coupled with other aspects of its rate regulations adopted last February, would "[e]ncourage operators to expand programming and service choices" and would "[s]timulate investment by companies that supply programming..."[10] And the Commission explained that "[t]hose services that will be subject to continuing regulation will be allowed to earn a competitive return."[11] This modest markup -- albeit substantially less than the 11.25% return allowed on an operator's investment in the provision of regulated cable services allowed under cost of service -- at least provides some

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6 Notice, ¶133.

7 Sixth Order on Reconsideration, ¶ 8.

8 MM Docket No. 92-266 (rel. Mar. 30, 1994).

9 Id. at ¶ 246, n.345.

10 Id. at ¶ 62-63.

11 Id. at ¶ 58.

incentives for operators to continue to invest in existing programming services. The revised going forward rules do not.

The Notice also suggests that the 7.5% percent markup may skew operator programming decisions by "creat[ing] an artificial incentive for the operator to continue to offer programming that the operator would not otherwise continue to offer."[12] This is hardly likely to be the case. Rather, failure to allow a markup will artificially skew operator decisions on programming investments. Moreover, as an operator's margin decreases over time, it will have diminished incentives to continue to carry a programming service on regulated tiers. Instead, an operator may, for example, choose to use that channel for unregulated services -- such as pay-per-view -- or to move an existing service to an unregulated per-channel offering.[13]

II. Retaining The Markup Fosters The Goal of Encouraging The Growth Of The Programming Industry

The Notice also suggests that the markup should be eliminated -- even for those systems that do not opt to use the 20 cent per channel formula for their new channels -- because "our rules permitting operators to pass through external costs are generally intended to compensate for added costs outside the operators' control and not to provide an additional mark-up without a clear policy goal."[14] But the Commission has already itself rejected this argument, stating that "[w]e do not believe that the cable operator's control over the costs in question should be the exclusive criterion for the selection of external costs. Thus, as discussed in the Rate Order, other objectives such as the continued growth of programming diversity may dictate different

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12 Notice, ¶133.

13 If the Commission modifies its rules to allow a limited amount of migration from regulated tiers, see Petitions for Reconsideration filed by Continental Cablevision and Cox Communications, MM Docket No. 92-266 (filed Jan. 5, 1995), failure to allow any markup will act as a significant disincentive to continued carriage of existing services on regulated tiers. In fact, a markup in excess of 7.5 percent may well be warranted.

14 Notice, ¶ 134.

criteria."[15] As explained above, the Commission adopted the markup based on a desire to serve that goal.

The Commission is well aware that cable programming costs historically have increased at a rate greater than inflation.[16] Cable programming services often are launched at low rates, with substantial growth in license fees occurring over time. These increases have helped fuel the growth in the rich diversity of new and original program offerings that cable networks have been able to provide.[17]

Even when increased costs can be recouped, however, under the rate regulation regime adopted by the Commission, failure to allow a markup on those costs results in decreased profit margins for operators.[18] For example, if programming costs rose by $1.00 prior to the proposed rules taking effect, an operator would earn a 7.5% markup--7.5 cents. But if no markup on subsequent programming cost increases is allowed, if programming costs rise to $1.50, an operator would still earn 7.5 cents -- or 5%. If they were to increase by an additional 50 cents to $2.00, the margin will shrink even further to 3.75% for this channel. Ultimately, those per channel margin reductions may force operators to operate with declining profit margins over

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15 First Order on Reconsideration, MM Docket No. 92-266 (rel. Aug. 27, 1993) at ¶ 90 (emphasis supplied).

16 Report and Order, MM Docket No. 92-266 (rel. May 3, 1993) at ¶251 ("The record shows that programming costs have increased at a rate far exceeding the rate of inflation.")

17 See, e.g., H.R. Rep. No. 628, 102d Cong., 2d Sess. 86 (1992) (noting that "since cable rates were deregulated in 1986, there has been an increase in the quality and diversity of cable programming").

18 See, e.g., Ex Parte Presentation of Lifetime Television to Meredith J. Jones (dated Oct. 13, 1994) (explaining "if the 7.5% mark-up on existing programming cost increases is deleted, operators will have little incentive to maintain existing programming services: their profit margins will actually decrease if they must absorb negotiated fee increases from the programmers without being able to pass on any amounts other than the actual costs.")

time.[19] The resulting reduction in cash flow margins -- viewed by financial analysts as one of the prime measures of cable operator profitability[20]--could have a negative effect by serving as a disincentive to invest in cable operations. Allowing only a straight pass through, without any markup, would therefore fail to keep operators in a neutral financial position. Instead, it would disadvantage cable operations and diminish their incentive to invest in existing programming services.[21]

Contrary to the Commission's assumption in its Notice, then, allowing a markup on programming costs does serve a clear policy goal -- providing some incentives for the continued investment in the growth and improvement of existing programming services.

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19 This effect is equally true for new services added to regulated tiers under the new going forward regime. Because operators may not earn a return on increases on those channels, their margins will erode on these channels as well.

20 For example, the most comprehensive source of communications industry financial performance is the annual Veronis, Suhler & Associates, Communications Industry Report. In the most recent Report, Veronis, Suhler puts forth as two key measures of cable profitability, "Operating Income Margins" and "Operating Cash Flow Margins.".

21 See, e.g., Letter from Stephen A. Brenner, USA Networks, to Meredith J. Jones, dated Oct. 14, 1994 (explaining that "deletion of the 7.5 percent markup would seriously disadvantage existing networks. While we believe that the percentage level is too low, it does provide cable operators with some incentive to maintain stability of services in regulated tiers in the face of increasing costs associated with the carriage of those services."); Comments of E! Entertainment Television, Inc., MM Docket No. 92-266 (Oct. 13, 1994) (explaining that in order for E! "[t]o continue to invest in the quality and vitality of programming services, we must be able to raise our license fee, reasonably, over time. If cable operators cannot maintain their level of return on their investment in new programming, they will not tolerate even our modest annual license fee increases, and we will see no growth in our revenue. This will seriously erode our ability to invest in programming, which ultimately adversely affects the breadth and quality of the product provided to the consumer."); Ex Parte Comments of United Video (filed Oct. 13, 1994) ("elimination of the mark up on existing program cost increases will severely disadvantage independent, established program services as they struggle to compete with the explosion of new program services being launched.")

III. The Commission Has Not Identified Any Problem Justifying Revisiting The Rules

When first adopting the programming cost pass through in April 1993, the Commission announced that it would "[m]onitor the impact of external treatment of programming cost increases. If it appears that this treatment is resulting in precipitous rate increases or is being harmful, we will take steps to limit these pass throughs, including subjecting costs to the cap."[22] Because the Commission's rate freeze prohibited pass throughs of any programming cost increases and the Commission's form explaining how to take pass throughs was not released until May 1994, rates could first be raised on account of programming cost increases only beginning in mid 1994--over a year after rate regulation was first imposed. The Commission, therefore, has only six months of experience with the workings of these pass through rules.

During that time, we are unaware of any evidence that the Commission's pass through rules have resulted in the "precipitous rate increases" or "harm" that would warrant reopening this issue. And the Notice fails to identify any reason for revisiting the markup based on any practical experience with the working of the pass through rules, or any evidence that a markup is unwarranted.

But even from a broader perspective, retreating on the markup is ill-advised. Operators and programmers only recently have had the entire rate regulatory regime explained. The revised going forward rules took effect just this month. Operators and programmers are finally beginning to adjust to the new regulatory environment in which they must operate. Undoubtedly, clarifications will continue that will affect the manner in which channels are added and revenues are generated.

The constantly changing regulatory landscape at the Commission has already taken a toll on operators and programmers. Rules adopted less than a year ago and which show no sign of generating "precipitous rate increases" should not be changed for no reason. Otherwise, the uncertainty factor alone will cause unnecessary additional harm to the industry just at a time

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22 Report and Order, at ¶251.

when it is finally adjusting to the new rules and attempting to get on with the business of serving subscribers with programming that they desire.

CONCLUSION

For the foregoing reasons, the Commission should maintain a markup on programming cost increases.

Respectfully submitted,

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